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I. TAIWAN: FRUITS OF FLEXIBILITY (7/25)

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Skillful use of economic incentives and a willingness to accept alternatives to normal diplomatic relations have enabled Taiwan to score significant gains in its quest for upgraded bilateral ties, acceptance in international organizations, and weapons suppliers other than the United States. Countries, notably in Europe, that had long held Taiwan at arms length are beginning to find Taipei's economic inducements more persuasive than Beijing's political demarches.

Taiwan decided last year to shift the focus of its diplomacy from establishing formal relations with small, impoverished countries to expanding and improving ties with major countries that recognize Beijing. Taiwan uses the lure of trade and investment, including arms deals and a promise of consideration on expensive contracts for its massive six-year development plan. By emphasizing substance over form and exhibiting unprecedented flexibility, Taipei has been able to register such gains as establishment of AIT-like offices and exchanges of cabinet officers.

Europeans respond. Pressed by their own business lobbies to facilitate economic links, European and other major trading countries are showing increased interest in Taiwan and less concern about the reaction from a PRC on the diplomatic defensive. Some countries may have been encouraged by the apparent warming of PRC-Taiwan relations, and some have adopted a strategy of granting the PRC benefits while dealing with Taiwan, hoping Beijing will not jeopardize its own ties by protesting too loudly.

Taiwan uses a variety of tactics to upgrade relationships, however incrementally, in the absence of diplomatic ties. It exchanges visits by high trade officials on nominally private missions (France, Italy), and by parliament members (UK, France) and other political figures. Taiwan also strives to upgrade the names, functions, staffing, and privileges of its own representative offices and welcomes others to do the same.

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Beijing reacts. PRC policy does not allow for Taiwan to function independently in any "official" international capacity, the goal being to force an isolated Taiwan into negotiations. In addition to démarches and protests, Beijing generally comes in right behind Taipei with its own offers, trade delegations, and high-level visits.

The PRC is especially sensitive to any possibly precedent-setting Taiwan breakthroughs, such as cabinet visits (France, Italy), admission to international organizations without Beijing's blessing, or major arms deals (France). Beijing may be considering downgrading diplomatic relations over major European arms deals with Taiwan, a strategy it employed against the Dutch in 1981-84. But Beijing may be reluctant to take this step given its desire to break all Western post-Tiananmen sanctions.

International organizations. On its admission to GATT, Taipei, rather than striking a deal with the PRC, as it appears to be doing to enter the Asia-Pacific Economic Cooperation forum, is attempting to override Beijing's objections by pressing the United States and the EC members for assistance. Taiwan's goal is not only to gain the very practical benefits of GATT membership, but, as important, to demonstrate its independent standing with the aim of ultimately forcing the PRC to accept it as an equal political entity.
(MFinegan) (CONFIDENTIAL)

II. CHINA: CRACKS IN THE IRON RICE BOWL (7/29)

Beijing has begun accelerating the pace of welfare reforms to address escalating costs, mounting frustration with existing programs, and the demands of an aging workforce. It also wants to pave the way for efficiency-enhancing enterprise reforms and enhanced labor mobility. Ideological reservations, however, and concerns about social stability are causing the leaders to move cautiously.

The cost of housing, retirement, unemployment, health care, disability, and other benefits for China's pampered state-enterprise workers roughly doubled in real terms between 1978 and 1988 and continues to rise. With a rapidly aging workforce, many state firms are losing money not because of inefficient management but because active workers must support a growing number of retirees. In an important departure from the past, Beijing now seeks to distribute the costs of welfare programs among the state, the enterprise, and the individual.

Making a house a home. Poor urban housing consistently ranks first on opinion surveys of complaints, rivaled only by anger over corruption. For 40 years token rents have failed even to cover maintenance costs, much less provide for new construction. With Beijing's encouragement, some 250 cities and counties are experimenting with reforms: phased, though significant, rent increases; privatizing some state housing; and establishing local funds to which all workers must contribute and from which they can

draw only to purchase housing. Shanghai and Guangzhou are among the reform leaders; Guangzhou already has sold six percent of its state housing stock.

Moving the safety net. In the mid-1980s Beijing set up local government-run programs to cover the cost of retirement benefits for state workers by pooling contributions from many enterprises. This began a process of trying to shift pensions, unemployment insurance, and other benefits from enterprise control. Experimentation has only begun, however, to create an unemployment-insurance program that could eventually permit implementation of existing bankruptcy legislation.

Even less has been done to reform enterprise-based medical insurance--the cost of which has increased more than five-fold over the past decade, when national income has only doubled--or the much-abused workers' compensation program. The government is only beginning to examine co-payment and premium schemes under which beneficiaries would bear a portion of the costs of health care and disability insurance.

Concerns and considerations. Beijing is serious about reducing costs and sharing expenses among state, employer, and individual, but the complexity of the undertaking, and worries about the public's capacity to bear the reforms, inhibits rapid or uniform implementation. Many enterprise managers welcome cost-cutting reforms, but others resist the loss of authority and resources entailed by welfare reforms; ideologues decry the dilution of the traditional benefits of the socialist welfare state; and local security officials fear possible popular opposition to erosion of benefits.

Even if successful, envisioned welfare reforms will affect only about 100 million urban state workers and their families. Tens of millions of other urban workers--and the three-fourths of the population that lives in the countryside--will continue to be left largely to their own devices to provide housing, health care, retirement, and other welfare benefits. (CClarke) (CONFIDENTIAL)

III. MONGOLIA: PURSUING A GOOD-NEIGHBOR POLICY (7/24)

Mongolian leaders know that the success of their economic and political reform efforts is closely tied to maintaining good relations with the USSR and China. Frustrated by mounting economic difficulties, some Mongolians nonetheless accuse the Soviets of everything from exploiting Mongolia economically to damaging its ecology. Others, particularly in the opposition, fear that hard-liners in Beijing are supporting conservative forces in Ulaanbaatar--a probably exaggerated fear.

Stabilizing Soviet ties. During this year's celebration of the 70th anniversary of Mongolia's revolution, July 1, Mongolian and Soviet participants alike were bitter about deteriorating relations.

But President Ochirbat and other senior officials are sympathetic to Moscow's travails and have tried to dampen criticism of the USSR; they prefer to attribute problems to economic disarray within the USSR rather than Soviet malice toward Mongolia.

Ulaanbaatar is pursuing separate contracts with Soviet republics in hopes of ensuring supplies of petroleum and food. According to Mongolian estimates, the USSR has not paid for \$110 million of copper delivered from the Erdenet mine; another \$100 million in goods that would normally be sold to the Soviet Union sits in Mongolian warehouses. Still, some progress was made when the Soviet-Mongolian economic commission met this month: Moscow reportedly agreed to reduce steep customs taxes on Mongolian goods and will resume enough barter trade to supply spare parts to the Erdenet mine and some power stations.

Cautious progress with the PRC. Obtaining access to China's ports and transport system is critical to Mongolia's plans to develop trade, and Ulaanbaatar has been willing to pay the necessary political price--which so far has been modest. Negotiations are continuing on giving Mongolia access to Chinese ports [REDACTED]

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[REDACTED] Eight new border crossings were opened in June, and air traffic was increased.

Ulaanbaatar postponed a visit from the Dalai Lama after Beijing threatened to cancel a visit by President Yang Shangkun later this year; the Dalai Lama will probably not be welcome to visit until after the Yang visit and completion of a port-access accord. The decision to defer the Dalai Lama's visit was doubtless difficult for Mongolian leaders, who have otherwise acted to facilitate the revival of the once-dominant Tibetan strain of Buddhism.

Beijing's dislike of Mongolia's rush to embrace political pluralism and market economics is evident--the PRC press has written disapprovingly of "political chaos" as the cause of its northern neighbor's economic woes. Chinese authorities worry lest democratization and nationalism in Mongolia appeal to fellow Mongolians in China.

Notwithstanding Ulaanbaatar's assurances that it has no intention of "subverting" China, Beijing is discomforted by discovery in China of documents prepared by one of the Mongolian opposition parties.

Some members of Mongolia's opposition assert that China is offering economic aid to conservative forces in the Mongolian People's Revolutionary party in hopes of slowing reform. Beijing probably did lecture Ochirbat about the dangers of embracing western economic and political ideas during his late-January visit to the PRC, but Chinese leaders are unlikely to risk direct involvement in Mongolian politics unless developments in Mongolia pose a direct threat to PRC interests. (DKingsland) (SECRET)

IV. DISCREET DEALINGS: CHINA'S CAUTIOUS APPROACH TO SOVIET REPUBLICS

Beijing is concerned about potential dismantling of the USSR and has no desire to become entangled in the power struggle between the center and provinces. The PRC needs to establish good relations with emerging provincial leaders but also supports the efforts of the central government to hold the USSR together. China has therefore opted for a low-key approach, evident during the July 9-16 visit of Kazakhstan's Nursultan Nazarbayev.

The Obvious Agenda. Ties between China and the USSR have been gradually developing at all levels and between various sectors, from economic and scientific to political and military channels--albeit at different speeds. Trade and investment and comparing experiences with reform have become staples of Sino-Soviet exchanges. Soviet republic representatives have taken part in border delineation talks between the two countries for the first time. Xinjiang officials accompanied Premier Li Peng to Moscow last April, presumably to discuss the two countries' respective problems with restive border nationalities.

Center Versus Periphery. While noting the "warm" welcome Nazarbayev received in Beijing from General Secretary Jiang Zemin, PRC press accounts of their meeting stressed the importance of "unity" and "socialism." China's two main current concerns about the USSR. In May, a PRC foreign affairs official remarked that internal ethnic and economic disruption posed the greatest threat to Gorbachev [redacted]

[redacted] Beijing is opposed to the splintering of the Soviet Union because it might have a disruptive effect on China's minority nationalities, particularly in Xinjiang and Tibet. China is also worried that weakening of the center will encourage Yeltsin and others to further undermine party power and legitimacy, an extremely troubling precedent for China's Communists.

Chinese press coverage of the Nazarbayev visit reflected Beijing's cautious approach to the republic issue, avoiding references to "sovereign Kazakhstan" which appeared in Soviet press. Beijing did not mention Nazarbayev's ambitious plans to form transportation links from China to Iran; instead PRC accounts focused on safer "traditional" economic linkages in areas such as provincial-level barter trade and science and culture as the main reason for the trip.

Keeping Radicals at Arm's Length. [redacted] B1

[redacted] While Beijing has refrained from public criticism of Yeltsin, or Gorbachev for that matter, it may have meant to signal support for more traditional elements with the June 20-29 visit of Russian Communist Secretary Polozkov. PRC press coverage was low-key, however, and did not repeat Polozkov's criticism of Gorbachev for "wholesale imposing of Western concepts" or his praise for the "leading role" of the Chinese Communist Party.

In general, China is still following Deng Xiaoping's prescription on Soviet affairs, avoiding public criticism and adopting a "wait and see" attitude. Deng's admonishment to "not take the lead" at the forefront of the dwindling socialist camp is still the watchword. (DKingsland) (SECRET//NOFORN//NOCONTRACT//ORCON)

V. CHINA: FRAGILE ECONOMIC RECOVERY (8/6)

China's mid-year economic returns show an upturn in industrial production that threatens to accelerate too fast, even as overall enterprise profitability--mainly of state-owned firms--continues to diminish. China's leaders seemingly prefer to keep credit to enterprises loose, exacerbating inflationary pressure, rather than tighten it and reckon with sharply decreased tax revenue and the social problems that would arise from increased urban unemployment and stagnant wages.

Growth at any price. Official Chinese statistics show that January-June GNP rose 6.1% over the same period last year. Industrial output accelerated steadily during the second quarter and was 13.4 % higher than the end of June 1990. Light industry--up more than 15%--expanded significantly faster than heavy industry--up less than 12%. Output of state-owned firms rose nearly 9%, a significant improvement over last year but less than half as fast as the increase posted by non-state firms.

Squeezed between rising production and overhead costs and government determination to keep increases in selling prices to a minimum, profits of major state-owned enterprises declined by nearly 18% during the first six months. Finance Minister Wang Bingqian estimates that enterprise defaults on taxes, profits, and fees owed the government have risen from about 12 billion to 21 billion yuan since the beginning of the year. (Were this trend were to continue through the remainder of the year, the amount in default would approach planned expenditure on national defense.)

Total enterprise debt default--payments owed mainly to banks and other enterprises--is estimated by Chinese economists to have reached as much as 150 billion yuan. The Bank of China, responsible for financing foreign trade, estimates that at the end of June payments overdue to it totaled \$1.1 billion. Styled by the Chinese a "chain of debt", sales of producer goods as well as semi-processed and raw materials are hampered by concerns over being paid, and in many sectors output continues to pile up in warehouses. Enterprises consequently depend ever more on banks to supply operating funds, even though loans ostensibly are made for investment.

Price trends. China's official retail-price index rose less than 2% during January-June over the same period last year. In part this apparent stability in prices reflects the way the index is calculated as well as selective price decreases taken to reduce stocks of

consumer goods. Another index, which measures the cost of living in major cities and which incorporates services and more market-priced goods, rose nearly 7% during the first six months, and for June alone was up nearly 11%.

Policy options. Chinese officials are concerned about the resumption of double-digit inflation but show no inclination to stop supporting financially troubled state-owned enterprises with a strongly expansionary money and credit policy. In a recent meeting with visiting World Bank economists, Chinese officials appeared to believe that inflation could be headed off by reducing aggregate demand. At least initially, the government probably will rely on tightening administrative controls in an effort to pinch back spending on consumption, especially by state enterprises and social organizations. (INR/EC:WNewcomb) (CONFIDENTIAL)